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December 14, 2007

AGENDA ITEM 3a

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Adoption of Policy on Inflation-Linked Asset Class and Three of its Components: Commodities, Inflation-Linked Bonds, and Forestland

II. PROGRAM: Total Fund

III. RECOMMENDATION: Recommend to the Investment Committee adoption of the Statement of Investment Policy for Inflation-Linked Asset Class and Three of its Components: Commodities, Inflation-Linked Bonds, and Forestland

IV. ANALYSIS:

<u>Background</u>
In September 2007, the Investment Committee (Committee) approved an Inflation-Linked Asset Class (ILAC) pilot program comprising commodities, inflation linked bonds, infrastructure and timberland. The Committee also approved the reclassification of existing investments into ILAC accounts as of September 30, 2007. In addition, the Committee stipulated that new investments in these programs will be subject to Committee approval of a governing policy, and further development of investment procedures and personnel structures.

As indicated, Staff is submitting the ILAC Investment Policy (Policy) for approval. Target allocations to all existing asset classes and the new ILAC will be recommended at the December 2007 Committee meeting as a separate item. Subject to Committee approval of the Policy and of a target allocation and retention of new Staff in the case of Infrastructure and Forestland, the ILAC would become a regular asset class.

An opinion letter from Wilshire is attached.

Description

The establishment of the ILAC is intended to provide an inflation hedge while diversifying CalPERS investments, thus mitigating losses during equity market downturns.

The Policy document consists of a master ILAC Policy and individual policies for three of the four ILAC components: commodities, inflation-linked bonds, and forestland. An infrastructure policy will be presented to the Committee in early 2008.

The investment policies for the commodities and forestland programs represent revisions to existing versions. The inflation-linked bond policy is new.

The title of the Timberland attachment is changed to Forestland in view of the more comprehensive strategies to be adopted as explained in the forestland policy. The Forestland Policy was presented to the Investment Policy Subcommittee in August 2007. This second reading is included within the ILAC per the Committee's direction. The enclosed Forestland Policy is very similar to the August version, except that guidelines concerning leverage and the allocation range have been clarified. Pension Consulting Alliance's opinion letter from the first reading of the Forestland Policy has been included for the Subcommittee's reference.

The proposed target allocation to the ILAC is five percent of the CalPERS total fund. The target allocation was discussed at the Asset/Liability Management Workshop in November 2007 and will be proposed in the Asset Allocation recommendation.

The target allocations to the four ILAC components were discussed by the SIO of Asset Allocation during the November 2007 Asset/Liability Management Workshop. The proposed allocation ranges are generally wide in recognition of the limited liquidity of forestland and infrastructure investments as well as the flexibility needed during the initial investment period.

The proposed benchmarks of the ILAC and of the four components are the benchmarks approved by the Committee in September, except that the commodities benchmark is changed to the S&P GSCI Total Return index. Previously the commodities benchmark was stated as S&P GSCI Excess Return index minus 0.25% fees plus the return of the collateral index consisting of cash and inflation linked bonds in a fixed ratio. The GSCI Total return index is approximately equal to the GSCI Excess return plus the return of T-bills. Since initially the cash collateral will be invested wholly in an internal STIF cash account it is appropriate to adopt the total return index as the benchmark and it is also operationally easier. The policy allows for the possibility of using inflation linked bonds as collateral in addition to cash at a later stage. However this will be on an opportunistic basis and not on a fixed allocation. Staff may review the commodities benchmark at a later stage once the portfolios become operational and the inflation linked bond portfolio becomes unitized like the internal STIF account.

V. STRATEGIC PLAN:

This item is consistent with Strategic Plan Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions. This item is also consistent with Goal IX, achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

As described in the September 2007 Investment Committee open session item 4c, the projected IL asset class staffing and consulting costs are $1.8 million for 2007-08 and $1.7 million for 2008-09. These projections include the costs of hiring the Staff needed to manage the infrastructure and forestland programs and also assist existing Staff manage the commodities and inflation linked bond programs.

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